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EXECUTIVE SECRETARIAT

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Executive Secretary

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THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

7 Nov 85

Date: 11/6/85 **Number:** 317018CA **Due By:**

Subject: Economic Policy Council Meeting -- Thursday, November 7, 1:00 P.M. -- Roosevelt Room

Economic

Revised

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☐	☐
Justice	☐	☑
Interior	☐	☐
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☐
HUD	☐	☐
Transportation	☑	☐
Energy	☐	☑
Chief of Staff	☑	☐
Education	☐	☐
OMB	☑	☐
CIA	☑	☐
UN	☐	☐
USTR	☑	☐
GSA	☐	☐
EPA	☐	☐
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REMARKS:

The Economic Policy Council will meet Thursday, November 7, at 1:00 P.M. in the Roosevelt Room.

The agenda and background paper are attached.

RETURN TO:

☑ Alfred H. Kingon
Cabinet Secretary
456-2823
(Ground Floor, West Wing)

☐ Don Clarey
☐ Rick Davis
☐ Ed Stucky

Associate Director

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THE WHITE HOUSE

WASHINGTON

November 6, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: EUGENE J. McALLISTER EM

SUBJECT: Agenda and Papers for the November 7 Meeting

The agenda and papers for the November 7 meeting of the Economic Policy Council are attached. The meeting is scheduled for 1:00 p.m. in the Roosevelt Room.

The single agenda item will be an economic review. Three papers, dealing with different aspects of the economy, have been prepared. In the first paper, Beryl Sprinkel examines the recent behavior of monetary velocity, and explores the implications for inflation.

In the second paper, Manley Johnson briefly reviews the prospects for real growth in the near future and examines the trade statistics and upcoming revisions to the national accounts.

In the final paper, Kathryn Eickhoff examines two aspects of the economy that have not performed well in recent quarters, net exports and inventories, and suggests that these elements of our economy may improve in the near term.

Attachments

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THE WHITE HOUSE

WASHINGTON

ECONOMIC POLICY COUNCIL

November 7, 1985

1:00 p.m.

Roosevelt Room

AGENDA

1. Economic Review

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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

November 5, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

From: Beryl W. Sprinkel

Subject: Velocity Behavior and the Threat of Rising Inflation

By June of this year, M1 had grown at a compound annual rate of nearly 12 percent and had risen well above its 4 to 7 percent target range. As a result, in July the Federal Reserve defined a new target range, 3 to 8 percent, and rebased the new target range to the second-quarter level of M1. This is shown in Chart 1; as the chart illustrates, the rebasing of the target range raised the targeted level of M1 by about $15 billion. Since the second quarter, M1 has grown at a compound annual rate of nearly 16 percent and has consistently been above the new target range.

There is considerable uncertainty about the meaning of the M1 growth that has occurred so far in 1985. On the one hand, many experts believe that the rapid growth of M1 in 1985 portends a similar rise in the inflation rate by late 1986 or early 1987; historically a rise in the trend rate of M1 growth has resulted in a subsequent rise in the inflation rate a year and a half to two years later. On the other hand, there are many who believe that the fundamental, historical relation between money growth and economic activity (and therefore inflation) has been altered by the deregulation of deposit interest rates that has occurred in recent years. The debate hinges on the behavior of velocity, or the relationship between the money supply and nominal GNP.

The Issue of Velocity Behavior

Historically, velocity has on average grown about 3 percent per year; the actual level of velocity and this 3 percent trend growth are illustrated in Chart 2. As is shown in the chart, deviations from trend growth have not been unusual, but recent declines have been large and long-lived by historical standards.

As Chart 2 illustrates, velocity has shown no net growth since mid-1982. The declines in velocity in 1981 and 1982 were not particularly unusual because velocity typically declines during a recession when lower interest rates and/or uncertainty often cause the public to increase money balances relative to spending. What was more unusual was that the decline (or slow

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growth) of velocity continued as the economy recovered in 1983. In 1984, however, velocity rebounded strongly (see Chart 2), growing at a 4.1 percent from the fourth quarter of 1983 to the fourth quarter of 1984. This led many analysts to believe that velocity growth would return to its traditional 3 percent growth path, after a downward level-shift in 1982-83. Since the fourth quarter of 1984, however, velocity has fallen at a 6.1 percent compound annual rate.

There are several competing explanations for the recent below-trend behavior of velocity. These include the effect of the deregulation of bank deposits and deposit interest rates; the effect of the decline in interest rates and inflationary expectations; the effect of the trade deficit and inventory swings; and the impact of volatile money growth on short-term velocity.

The critical issue for policymaking is whether we are only observing the effect of one or more transitory factors that are temporarily depressing velocity growth, or whether a permanent change in the trend growth of velocity has occurred. The former would imply a change in the level of velocity, after which velocity could proceed along its 3 percent historical growth path, but at a permanently lower level. This possibility is labeled path A on Chart 3. The case of a permanent change in the trend growth of velocity would entail a different growth path. Two reasonable possibilities are labelled paths B and C in Chart 3. Path B implies a positive growth rate of velocity (1 percent), but a lower growth path than has historically been the case; path C defines a zero-growth path.

A growth path such as B or C, in which velocity permanently grows more slowly, means that higher money growth rates would be needed to support a given level of economic activity. Moreover, the economy could absorb more money growth without generating inflation. If, however, velocity is only being temporarily suppressed and can be expected to return to its historical growth path (path A in the Chart 3), historical standards of prudent, noninflationary money growth remain intact. In that case, the periods of rapid money growth in 1982-83 and so far in 1985 appear more than adequate to offset the level shift in velocity and the current rate of money growth, if continued, would imply a substantial reacceleration of inflation.

The Effect of Deregulation on Velocity

The deregulation of bank deposits can have both a transitory and a permanent effect on velocity behavior. When new types of deposits accounts are introduced, the new deposits can induce shifts of funds into or out of the monetary

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aggregates. Such a shift of deposits can have a temporary effect on money growth rates and consequently, can cause considerable uncertainty in the short run about the meaning of observed money growth rates. These deposit shifts are by definition temporary, however, and will therefore not have a lasting effect on money growth or velocity once the deposit shifts are completed.

A permanent change in velocity growth requires a change in the public's behavior with respect to holding money balances and spending. Such a fundamental change may well have resulted from deregulation. Because of the introduction of interest-bearing checking accounts (NOW accounts in 1981 and Super-NOW accounts in 1983) and their inclusion in M1, some M1 assets now function partially as savings accounts. The public may therefore choose to hold larger M1 balances for a given level of spending. If so, the introduction of interest-bearing accounts in M1 may be having the effect of reducing permanently velocity growth.

In addition, it is possible that the inclusion in M1 of interest-bearing deposits has altered the public's reaction (in terms of holding money balances) to changes in interest rates. Historically, velocity and interest rates have tended to move together. That is, when interest rates fell, there was less incentive to reduce cash and other non-interest bearing assets. As a result, M1 balances would build up and velocity growth would slow. For this reason, velocity growth has historically slowed during recessions, when interest rates usually fall. Conversely, velocity has grown more rapidly during economic expansions when interest rates frequently rise; with higher interest rates, there was a greater incentive to economize on cash and non-interest bearing (M1) assets and the spending/M1 ratio would rise more rapidly.

This historical reaction to interest rate movements may have been altered by the inclusion of interest-bearing deposits in M1. When interest rates decline, the fact that some M1 assets now pay interest means that M1 balances will tend to grow more rapidly, depressing velocity more than has traditionally been the case. Some analysts partially attribute the rapid money growth since the fall of 1984 to the 300 to 400 basis point decline in interest rates that occurred from fall, 1984 to June, 1985. While this explanation has some theoretical appeal, it does not explain why M1 has continued to grow at a 15 percent pace since June.

Factors That May Temporarily Suppress Velocity

Some analysts have attributed the unusually sluggish growth of velocity to the increased severity of inventory

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swings over this cycle and the unprecedented deterioration of the trade balance. The increased trade deficit means that a larger share of the domestic spending,provided for by money growth, is satisfied by imports and does not show up in domestic production (GNP). Some argue that the traditional velocity expression has grown more slowly because of this "wedge" between domestic spending and domestic production represented by the trade deficit. By the same reasoning, large swings in inventories (relative to historical experience) may account for more volatile velocity behavior as domestic spending translates into more/less inventory accumulation, rather than production.

The argument about the trade deficit implies that the foreign producers, who receive dollars in return for the goods we import, horde these dollars in their mattresses. These dollars ultimately return to the U.S. economy in the form of capital inflows which stimulate domestic economic activity. That is, this contention is incomplete; it ignores the positive impact of net capital inflows which are the flip-side of the trade deficit.

The effect of both the trade and services deficit and changes in inventories can be accounted for by calculating velocity using final sales to domestic purchasers (which includes changes in inventories and imports and excludes exports). If either changes in inventories or the external imbalance has been the cause of the observed abnormal velocity behavior, then this calculation of velocity (sales to domestic purchasers divided by M1) should not demonstrate any aberration. This is not the case. There is little difference between this and the traditional measure of velocity over the past five years. Consequently, neither the external deficit nor inventories swings appears to be a factor contributing to the prolonged deviation of velocity from its trend.

It is also reasonable to suspect that a part of the unusual fluctuations in velocity in recent years is simply due to the increased volatility of money growth. This argument relates to the dynamic relation between GNP and money growth, rather than to any change in public behavior. Because of the lag between a change in money growth and its effect on economic activity, volatile money growth induces volatile velocity behavior. If, for example, money growth is accelerated, its effect on the economy occurs two or three quarters later; in the meantime, observed velocity (GNP/M1) will be temporarily depressed. In recent years money growth has been more volatile; in addition, there have been repeated episodes when money growth accelerated substantially. In these instances, velocity would be expected to be temporarily suppressed until the lagged effect on the economy (GNP) takes place.

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Summary and Outlook

It is not possible to conclude with certainty the cause of recent velocity behavior. A number of factors -- some temporary, some possibly permanent -- are at work to suppress velocity growth and until more time passes, it is not possible to disentangle these effects.

My best judgement is that it is reasonable to expect velocity growth to be slower in the future than it has been historically. This is because the new deposit accounts included in M1 have some attributes of saving deposits. It therefore seems plausible that velocity growth will in the future be in the 0% - 2% range. In addition to this change, the unusual declines in velocity recorded in recent years are probably attributable to some of the transitory factors discussed above, including the fact that money growth itself has been volatile and has risen sharply in several periods in recent years.

If velocity growth settles into a slower trend, a path similar to that depicted by line B in Chart 3 seems plausible. That implies a slightly higher path for noninflationary money growth than if the trend of velocity growth were 3 percent, but it does not rationalize the excessive rate of money growth that has occurred so far this year.

It is important to recognize that even when the uncertainty about velocity behavior is taken into account, there is no theoretical or empirical justification for the money growth that has occurred so far this year. That is, abstracting from all the potential explanations for sluggish velocity growth, it is clear that M1 growth has been fundamentally strong. Given the uncertainty about the causes of recent velocity behavior, current monetary policy is subjecting the economy to the risk of a serious reacceleration of inflation, unless money growth is gradually curtailed beginning immediately.

While a reacceleration of inflation is not likely in the next six months, it is likely that we are at or near the low point of inflation. Several transitory factors -- including the decline in energy prices, the appreciation of the dollar and favorable agricultural harvests -- have added disinflationary pressure to the general price level in recent years. These disinflationary forces cannot be expected to continue. The dollar has already depreciated about 20 percent since February 1985.

A year ago, the year-over-year rate of M1 growth was 6.2 percent; today it is nearly 11 percent. With the trend rate of money growth rising, the fundamentals imply an increase in

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inflation over the next few years. The longer money growth is allowed to continue at recent excessive rates, the higher the probability that the acceleration of inflation will be significant.

The recent actions to attempt to depreciate the dollar increase the risk of a resurgence of inflation. There has been extensive research indicating that sterilized intervention to alter exchange rates is generally ineffective; at best, it has a short-lived impact. However, if intervention to reduce the dollar is not sterilized, domestic money growth is increased. Given that money growth is already too rapid to be consistent with continued low inflation, the efforts to push down the dollar raise the risk of higher inflation in the future.

Exchange rates are determined by a country's economic conditions, policies and outlook. One of the surest ways to depreciate the dollar would be to allow inflation to resurge. The cost of such a depreciation, however, would be the erosion of the noninflationary environment that has characterized this expansion.

The Federal Reserve is not likely to act to restrain money growth until a more rapid rate of economic growth or higher inflation is actually observed. In the meantime, the Fed is targeting the Federal funds rate at around 8 percent, and thereby money growth is not being explicitly controlled.

There is already considerable evidence that real economic growth is rebounding. Stronger economic growth in general implies higher short-term interest rates, unless the Fed offsets the upward pressure on rates by increasing reserve growth. With the Federal Reserve designing its policy actions to stabilize the Fed funds rate, higher reserve and money growth will result as the economy expands. Thus the needed slowdown in money growth is not likely to occur with the Fed's current policy procedure; this is even more the case if the Fed is engaging in unsterilized intervention to bring down the dollar.

Thus the current policy of the Federal Reserve is a highly risky one. Recognizing the uncertainty about velocity behavior, there is no reason to believe that we can allow the current rate of money growth to continue without an eventual reacceleration of inflation. Even if velocity behavior has changed so radically that it exhibits no trend growth at all (path C in Chart 3), the 13 percent money growth that has occurred this year implies sharply higher inflation by late 1986 or early 1987.

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If the Administration's assumption of 4 percent real growth is correct and velocity growth is zero, 13 percent money growth that is sustained into the future implies 9 percent inflation. Given the lag in the effect of money growth on inflation, this threat of rising inflation is not imminent. Nor is it inevitable, if the Fed acts immediately to gradually decelerate money growth. Such a policy would limit the probability of a rise in inflation as well as the size of any increase in inflation. It is therefore currently the risk-minimizing policy.

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CHART 1

ALTERNATIVE M1 TARGET RANGES FOR 1985

Weekly Averages of Seas. Adjusted Data

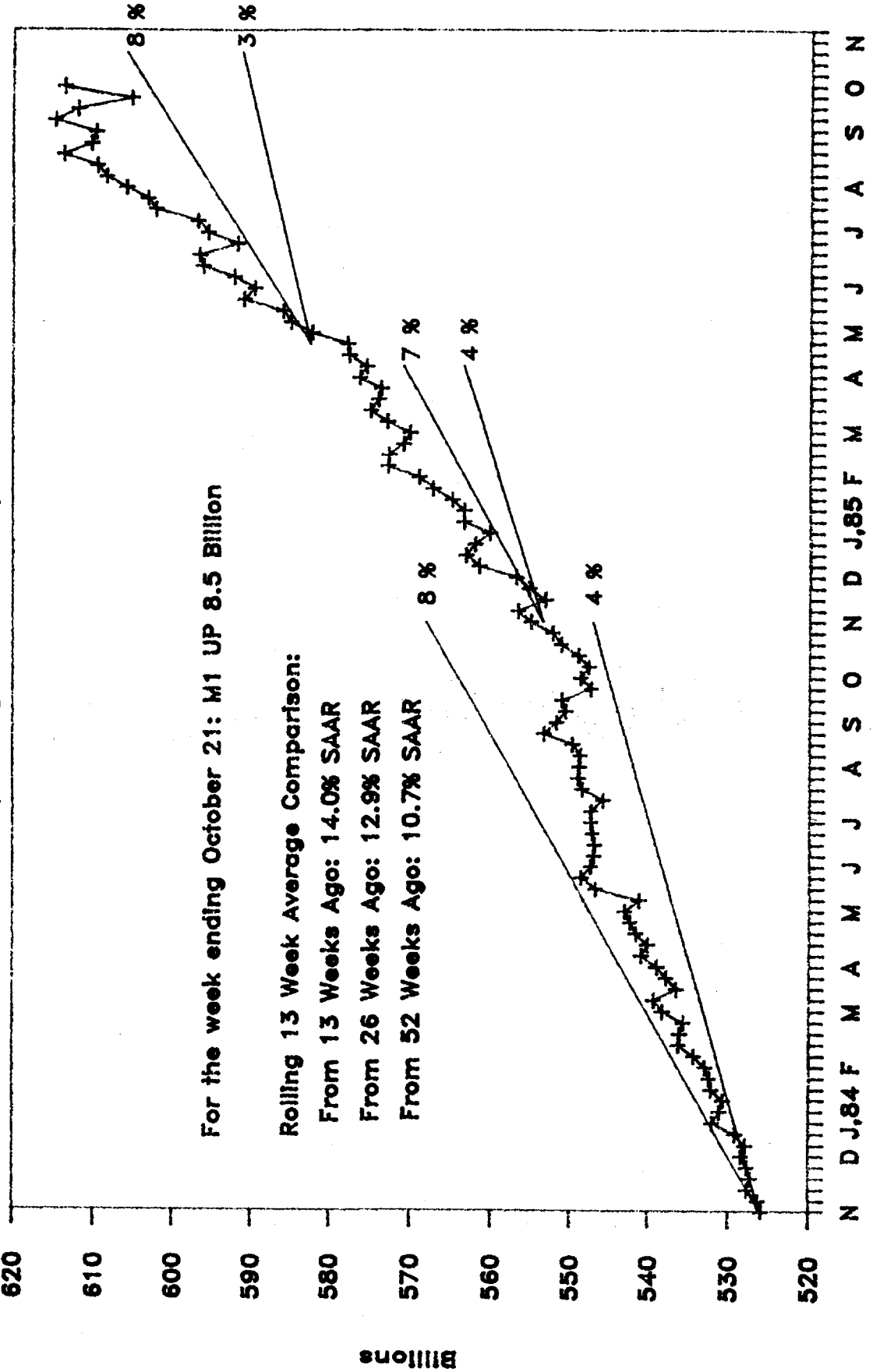

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CHART 2

VELOCITY OF M1

Nominal GNP Divided By M1

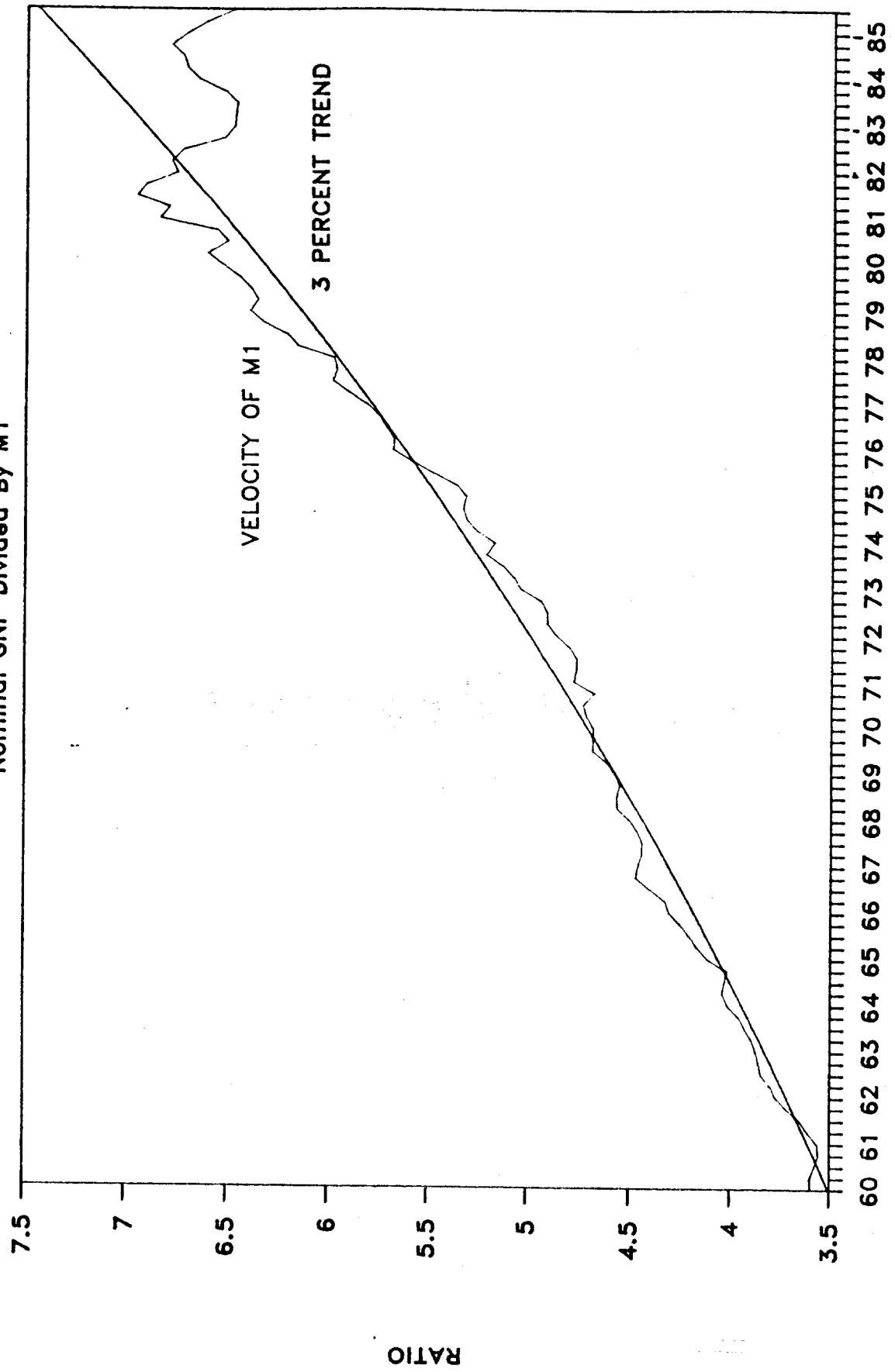

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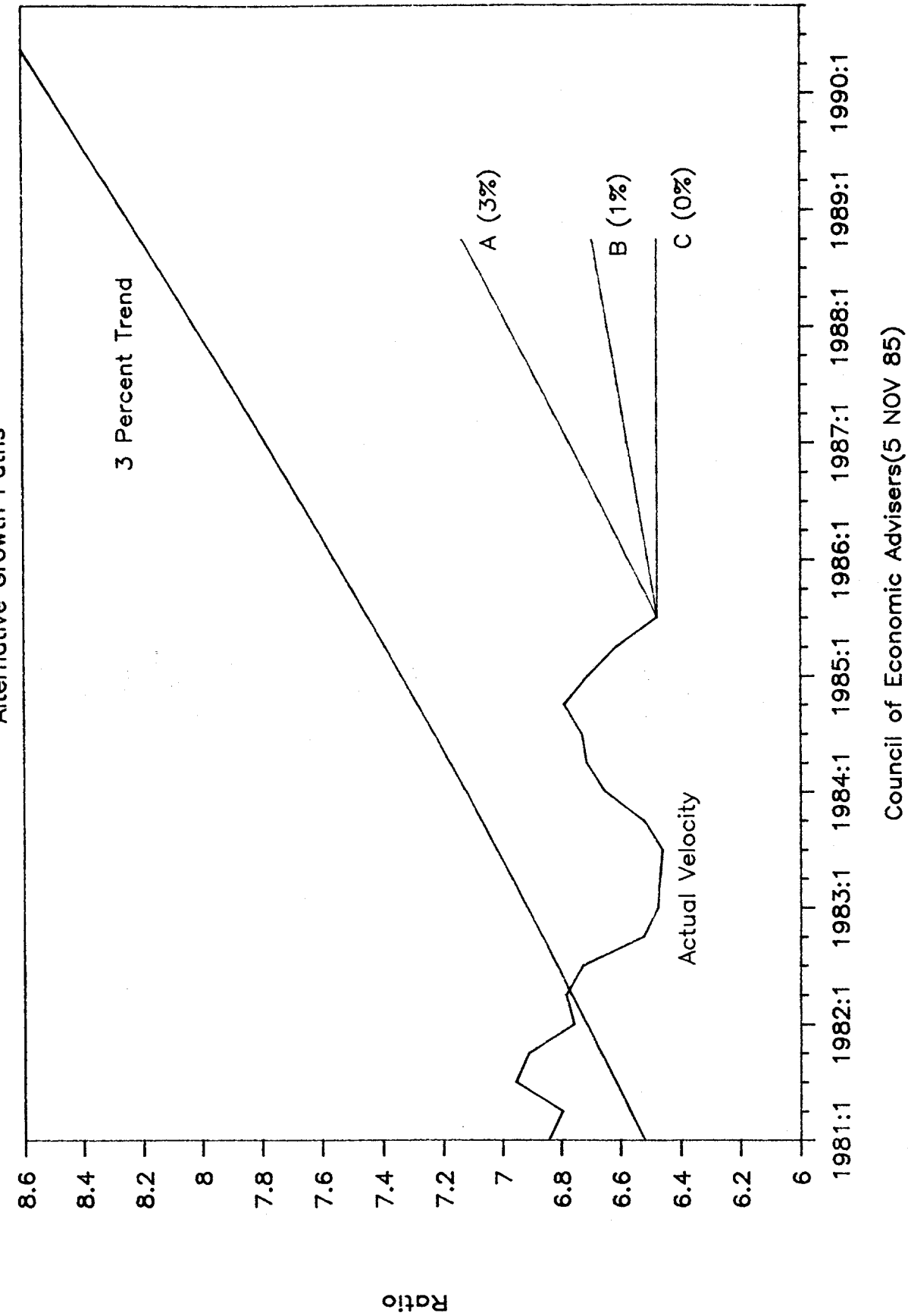
Chart 3

VELOCITY OF M1

Alternative Growth Paths



Council of Economic Advisers(5 NOV 85)

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Briefing on the Domestic U.S. Economy

Introduction

Signs are emerging that the economy is pulling out of the phase of sluggish growth that has extended from mid 1984, but it is not clear how vigorous any rebound will be. Data problems, particularly the very large errors recently uncovered in the trade statistics cloud our understanding of how the economy has actually been performing. Forthcoming in late December will be a complete overhaul of the national accounts. It will include a fix for the errors in the trade data and also a number of other conceptual and statistical changes and may provide a different perspective on our economic performance over recent years.

Profile of the Expansion to Date

Total real GNP growth over the first 11 quarters of this expansion has been about on par with the past postwar expansions which extended at least that far. (Chart 1. The level of real GNP in the third quarter was just 0.6 percent below the past expansion trend.)

- Growth during this expansion falls into two phases -- rapid gains at a 7.1 percent annual rate during the first six quarters followed by a slower phase over the next five quarters when growth averaged only 2.2 percent. The second chart attached breaks out growth during these two phases.

- Inventory investment helped boost growth early in the expansion but held down growth during the second phase. In this accounting sense, the deteriorating net export balance lowered measured real growth throughout this expansion. Until recently business capital spending provided a major thrust behind the early expansion.

Signs of Some Reacceleration

Hopefully, we are moving into a third phase, one which will contain faster growth. One sign of this is the acceleration of real growth to 3.3 percent in the third quarter. (Figure is subject to revision in two weeks. September trade data could nudge it down,

though other returns, yet to come in, could work in the opposite direction.) Other indicators of a better tone to the economy include:

- Employment gains were strong in October. The employment rate -- ratio of persons employed to the population of working age -- moved up to an all-time high. The rise in employment reported in the survey of business establishments was especially strong. Some of that pickup may have been due to biases related to some technical factors, but even taking the average of October and September (which may have been biased downward), the two-month gains in employees on private payrolls of 230,000 were well ahead of the roughly 175,000 averaged during the spring and early summer.

- New orders placed with manufacturers show signs of perking up. (Chart 3 presents the trend of total real new orders for durable goods -- a leading indicator of production.)

- The stronger new order bookings reflect some firming of orders for capital equipment after declines late in 1984 and early this year (chart 4), but more importantly fairly tight business inventory positions. One sign of the move to replenish stocks is the 6 percent annual rate increase in the third quarter from the first in orders placed with producers of materials and supplies. These orders had declined through the later part of 1984 and into 1985.

- Some improvement in housing starts appears probable. Lower mortgage rates tend to lead to improvement in starts with a little lag. Also favorable, in places where building permits are required, those permits have been running ahead of starts by an annual rate of 150,000 units over the past five months.

- Inflation remains moderate. The CPI in September was up by 3-1/4 percent from a year earlier, and the trend is downward (Chart 6). So far this year, producer prices at the finished goods level have actually edged down fractionally. On the other hand, rates of growth of wage rates appear to be leveling off after slowing steadily from the turn of the decade, according to the employment cost index which is our most reliable indicator of wage movements (chart 7).

- There are some pluses among developments in financial markets, which so far have taken in stride the large volume of bond offerings and the highly publicized reports of problems of Farm Credit Banks and other institutions. The structure of interest rates is down 100 to 150 basis points from 1985 highs of late last winter, and from late summer 1984 short rates are off more than 300 basis points, while long rates are down by 200 basis points or more.

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-- Behind this showing is a more accommodating monetary policy by the Federal Reserve and also large inflows of capital from abroad which have supplemented domestic saving. Further, and favorable for the near-term outlook, nonfinancial corporations in the third quarter were able to cover total capital expenditures from internal funds, which is unusual at this stage of an expansion (chart 8).

-- There are isolated cases of higher risk premiums being attached to securities (e.g., paper of the farm credit banks), but generally these premiums have not become large, as they would in a period of financial stress. Chart 9 shows that the spread between AAA and BAA bonds is well below levels of a few years back.

o The stock market has been hitting new highs based on the Dow and is close to highs based on other measures. The S&P 500 held about flat from early 1983 through December 1984, but since has climbed about 16 percent.

Caution Is Still in Order

The foregoing appears to add up to some further acceleration of real growth in the current quarter, though there are still some question marks in that outlook. Some of any acceleration will represent stepped-up building of inventories in the nonauto sector. (Auto inventories will be sharply higher, but that will merely offset the drop in sales this quarter from the high levels of the third when sales were boosted by financing incentives.) For the year 1986, there are still some uncertainties on the horizon.

o Consumer spending pretty much sustained the expansion during the first three quarters of this year, as it grew by a rate of about 5 percent in real terms while the total of all other components of real final sales were about unchanged. A 20 percent annual rate rise so far this year in consumer installment debt on top of a 20 percent increase last year, plus the exceptionally low personal saving rate currently, may point to slower growth of consumer spending.

o The outlook for capital spending is cloudy, despite a firmer tone lately to capital goods orders. The McGraw-Hill survey of business plans for plant and equipment outlays (to be released on November 8) indicates a cutback in capital spending in nominal terms by about 2 percent next year from 1985. While these surveys of business intentions can be wide of the mark, it is unusual in this fall survey for businesses to report a decline in planned spending for the forthcoming year. In the last three instances when they did so (for the years 1983, 1961, and 1958), business capital expenditures actually did decline.

- Of course, slower growth of consumer spending and sluggish capital outlays may not be mutually consistent developments. If consumers step up rates of saving at the expense of current consumption, that would free up additional funds for capital markets and help sustain the rate of business fixed investment.

The current expansion is now in its 36th month, which means that it is relatively mature, at least in terms of duration. The average of postwar expansions is 45 months, and excluding the expansions extending into the Korean and Vietnam Wars, the average is 34 months (chart 10).

- Of course, expansions do not end mechanically after so much time has expired. Rather, they typically come to an end because of excesses which set correcting forces in motion. Currently, there are few signs of such excesses, and little reason to expect an actual downturn.

Trade Statistics

Turning to the statistical underpinnings which enable us to track the economy, errors in the merchandise trade data have clouded our understanding of economic performance over the past couple of years. Monthly trade data have been based on the date of receipt of documents by the Census Bureau from the Customs Service. Only recently has Census checked to see how closely this procedure matches the actual dating of transactions. It was found that a substantial portion of figures reported for a particular month actually represented transactions of an earlier month. For imports this "carryover" was especially large and highly variable, ranging this year as high as 53 percent and as low as 39 percent of the reported monthly figure. These errors in the trade statistics have imparted artificial movements to the quarterly balance of payments accounts and to GNP.

- Commerce Department estimates that correction of these errors in the trade figures will result in a much smoother growth path for real GNP during 1984 and into this year. For the three quarters 1984-III to 1985-I, the jagged growth pattern of 1.6 percent, up to 4.3 percent, and then to 0.3 percent will be replaced by a much smoother track (abstracting from other changes to the national accounts, discussed below). The level of real GNP corrected only for these trade statistics would be about the same in the first quarter of this year as now carried in the national accounts. Growth was probably little affected in the second quarter. All the returns are not yet in for the third quarter. Imports jumped sharply in the reported figures for September, but some of that possibly represented faster reporting of actual

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September transactions so that there will be less spillover into future months We won't know this for some time.

Revisions to the National Accounts

The framework of the national accounts will change in late December when Commerce releases the results of the benchmark revision. This is part of their regular program of reworking the accounts to incorporate results of economic censuses and all the other newly available data and also to implement conceptual changes to keep pace with the changing structure of the economy. These revisions will include corrections to the trade data (which can only be made back to early 1983) and will also incorporate several other major changes:

- Estimates of the underground economy, or more correctly, unreported income, will be refined. For the year 1977, for which revised estimates have already been reported, these and other changes, raise the personal saving rate by nearly one percentage point. That margin on the saving rate should carry through to recent years.

- The base year for calculating price deflators and constant-dollar GNP will be switched from 1972 to 1982. There were enormous swings in some relative prices between those two years -- e.g., an elevenfold increase in world oil prices. Thus, the composition of real GNP will look quite different with the new deflators. Typically, when the accounts are rebased to a more current year, real growth rates over prior years are reduced. Commerce has already reported that the shift to 1982 dollars would shave 0.4 percentage point off the yearly growth rate for the period 1972 to 1984, if no other changes were to be made. Of course, other changes will be implemented, providing a number of offsets in the opposite direction.

  -- The result of rebasing underscores the fact that the closely followed real growth rates are quite sensitive to the base year chosen.

- The price deflator for computers will be adjusted for quality improvements. In the current set of accounts, this deflator has been arbitrarily held constant. In the new set of accounts, the deflator will be declining sharply over time, reflecting the fact that today's desktop PC has as much or more power as a mainframe of 20 years ago. Purchases of computers have been growing rapidly, and now represent nearly one-tenth of total business capital spending. Given that the accounts are being rebased to 1982 dollars, this change in the treatment of computers won't have much impact overall on real growth rates for past years. However, if trends continue, this change in the

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treatment of computers will mean that their weight will increase rapidly in the future, boosting the measured growth of real business capital spending and the real stock business capital.

-- This change means that it will be even more important to look at capacity utilization rates as well as stocks of capital, as today's PC is so cheap that it may sit on a desk unused for much of the day, while the 1965 mainframe was so expensive that it was kept running nonstop.

Those are the major changes. There will be a great many minor changes as well. From this vantage point, it is impossible to tell how they will all add up.

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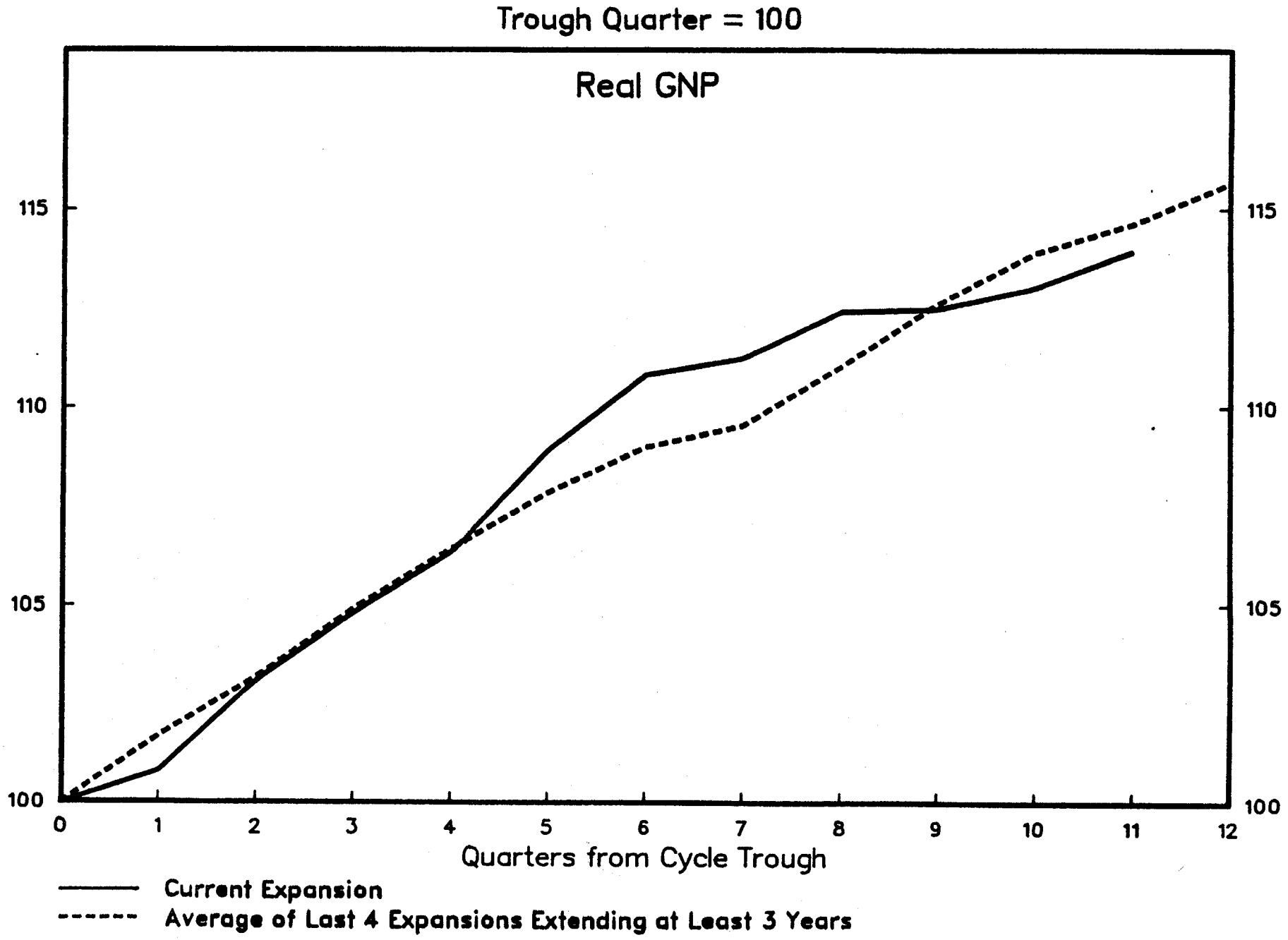
Expansion Comparisons



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COMPOSITION OF REAL GNP GROWTH DURING THIS EXPANSION

		Phase 1 1982-IV to 1984-II	Phase 2 1984-II to 1985-III	Change Phase 1 to Phase 2
		(Percentage point contribution to growth)		
+	Consumer spending	3.9	2.5	—1.4
+	Business fixed investment	1.9	0.7	—1.2
+	Residential construction	0.8	0.1	—0.7
+	Government	0.1	1.1	1.0
=	Final sales to domestic purchasers	6.7	4.4	—2.3
+	Net exports	—1.6	—1.1	0.5
=	Final sales	5.1	3.3	—1.8
+	Inventory investment	2.0	—1.1	—3.1
=	Total real GNP growth	7.1	2.2	—4.9

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Chart 3

Real New Durable Goods Orders

(Billions of 1972 Dollars)

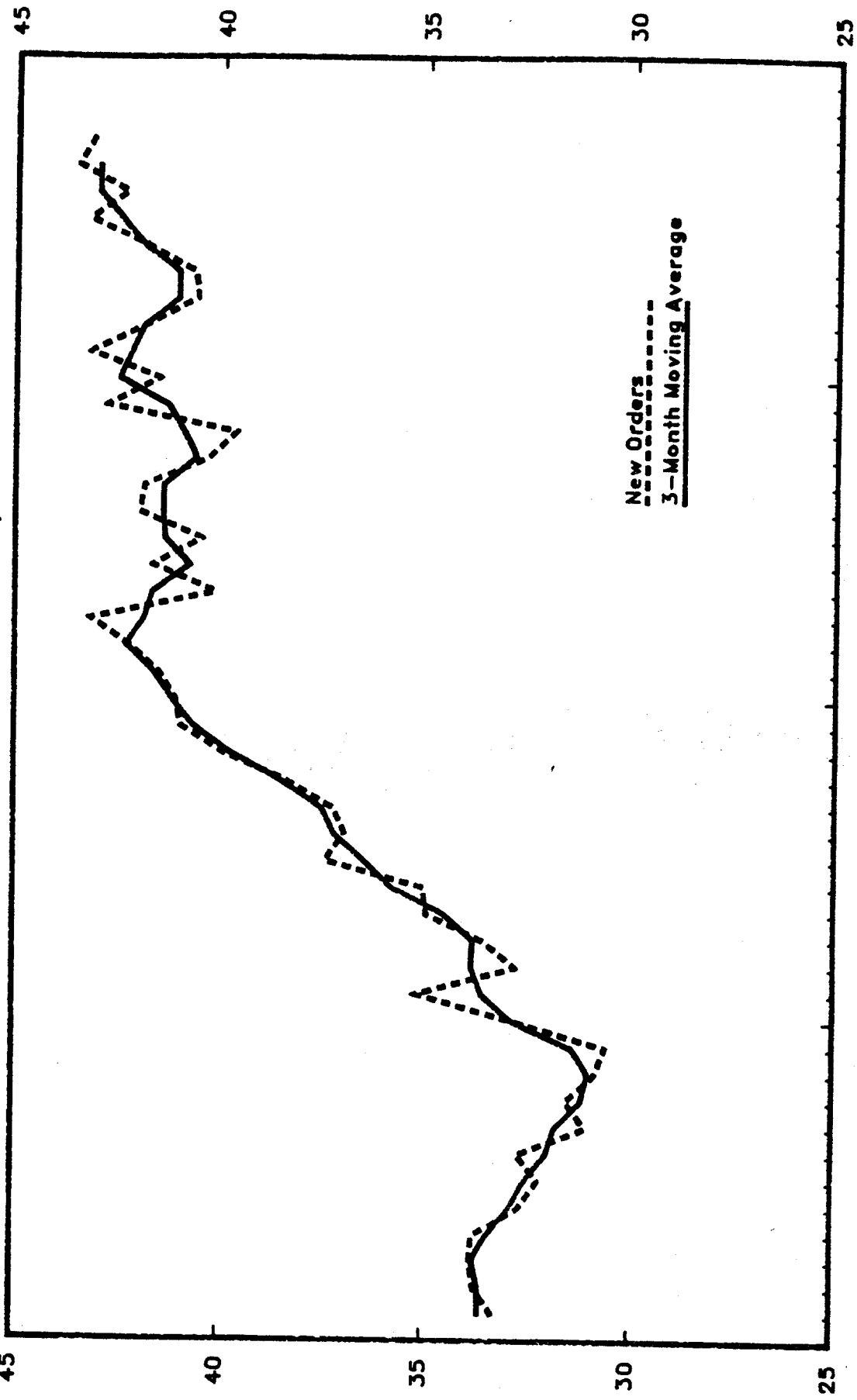

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Chart 4

Real Nondefense Capital Goods Orders

(Billions of 1972 Dollars)

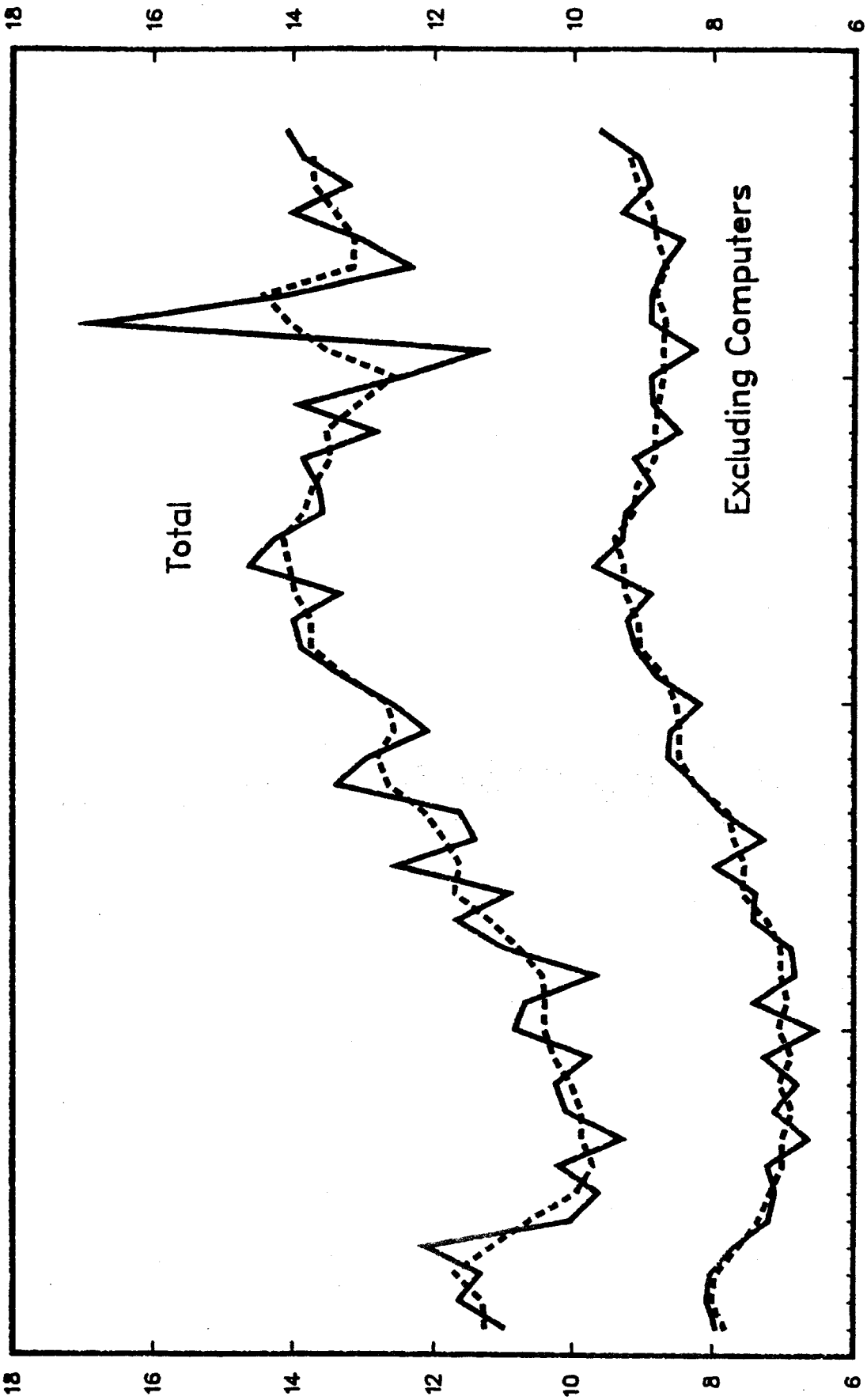

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Chart 5

New Housing Starts and Mortgage Interest Rates

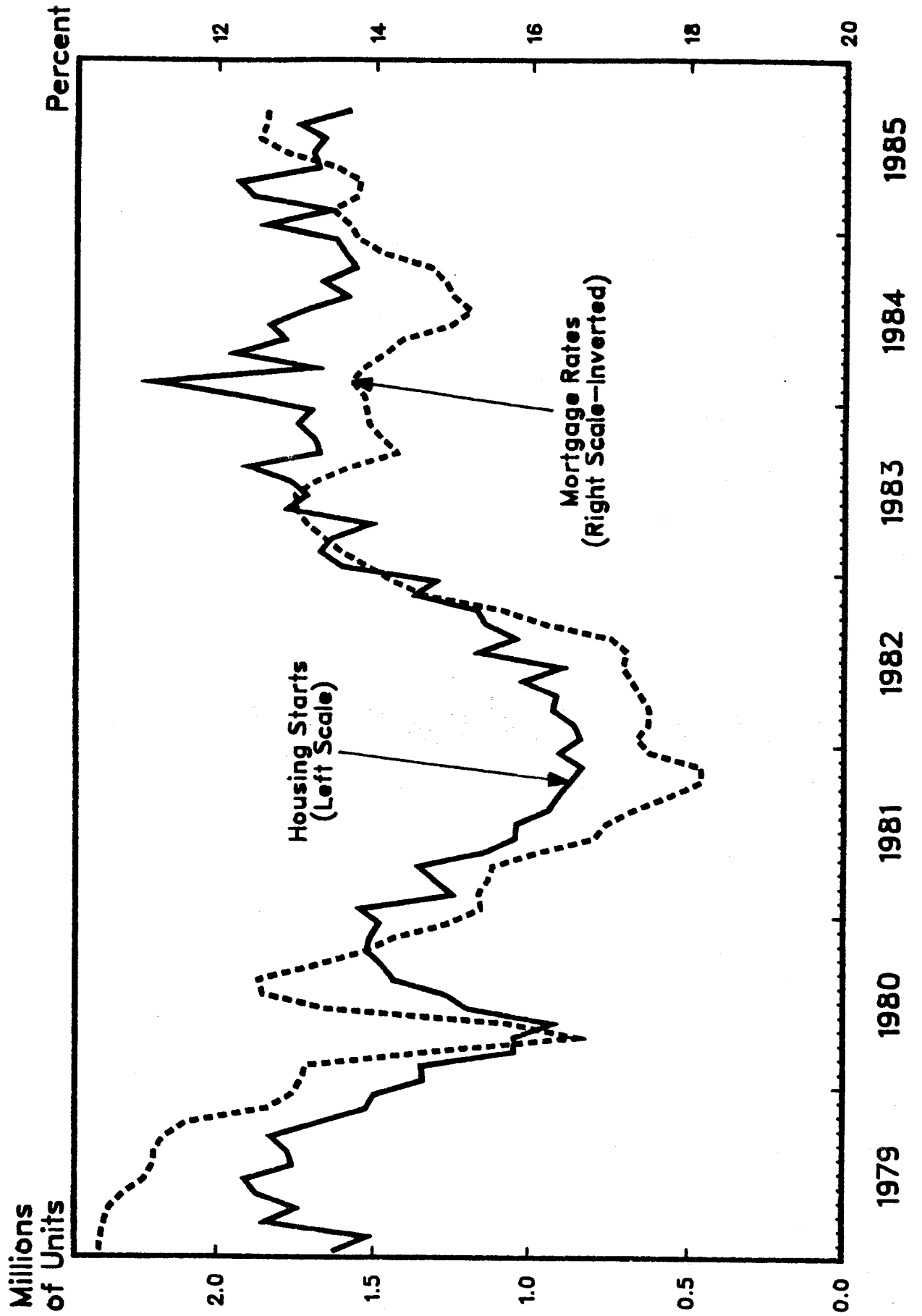

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Chart 6

CHANGE IN CONSUMER PRICES

(Percent Change from Year Earlier)

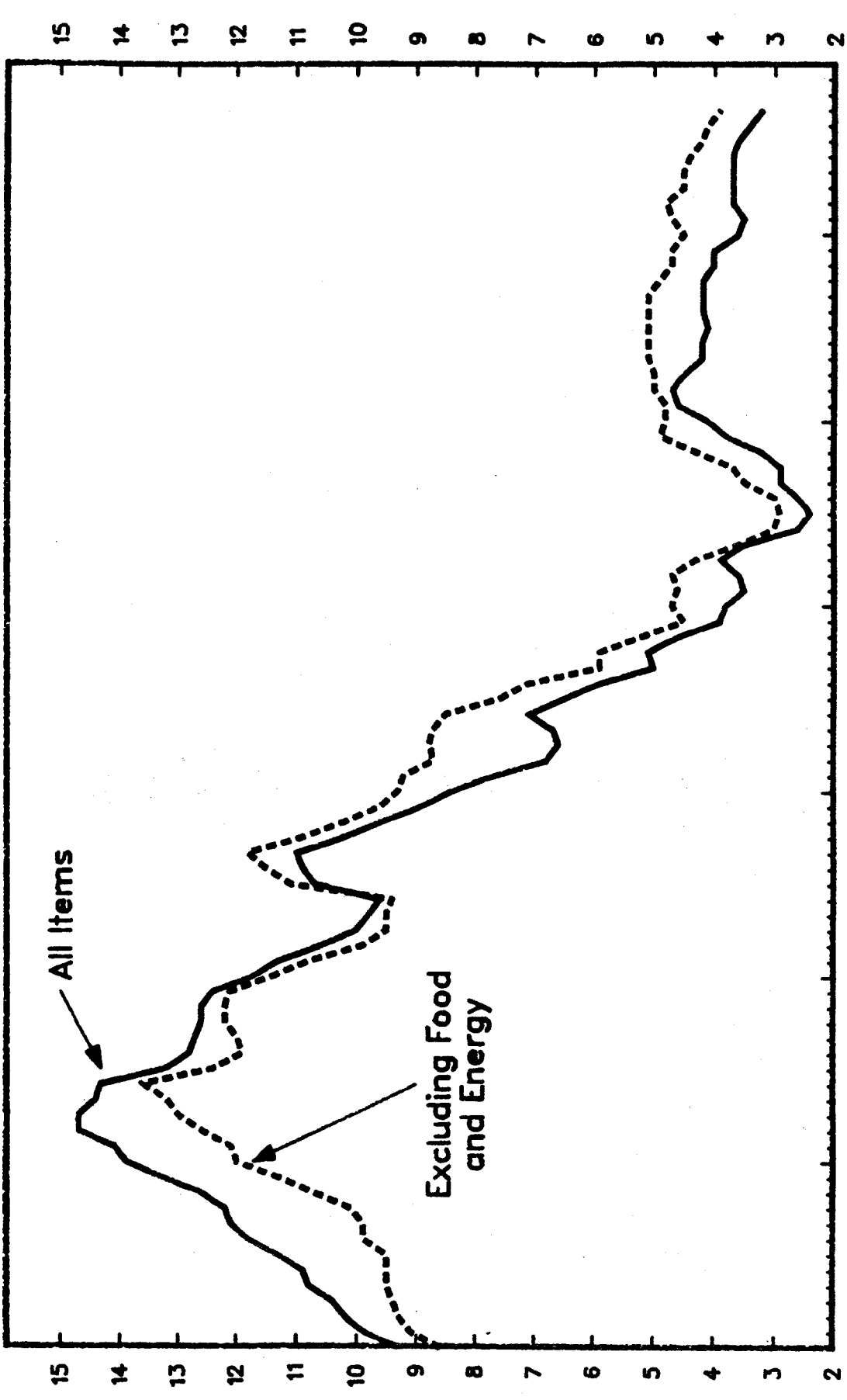

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Chart 7

Employment Cost Index: Wages and Salaries of Private Nonfarm Workers

(Percent Change from Year Earlier)

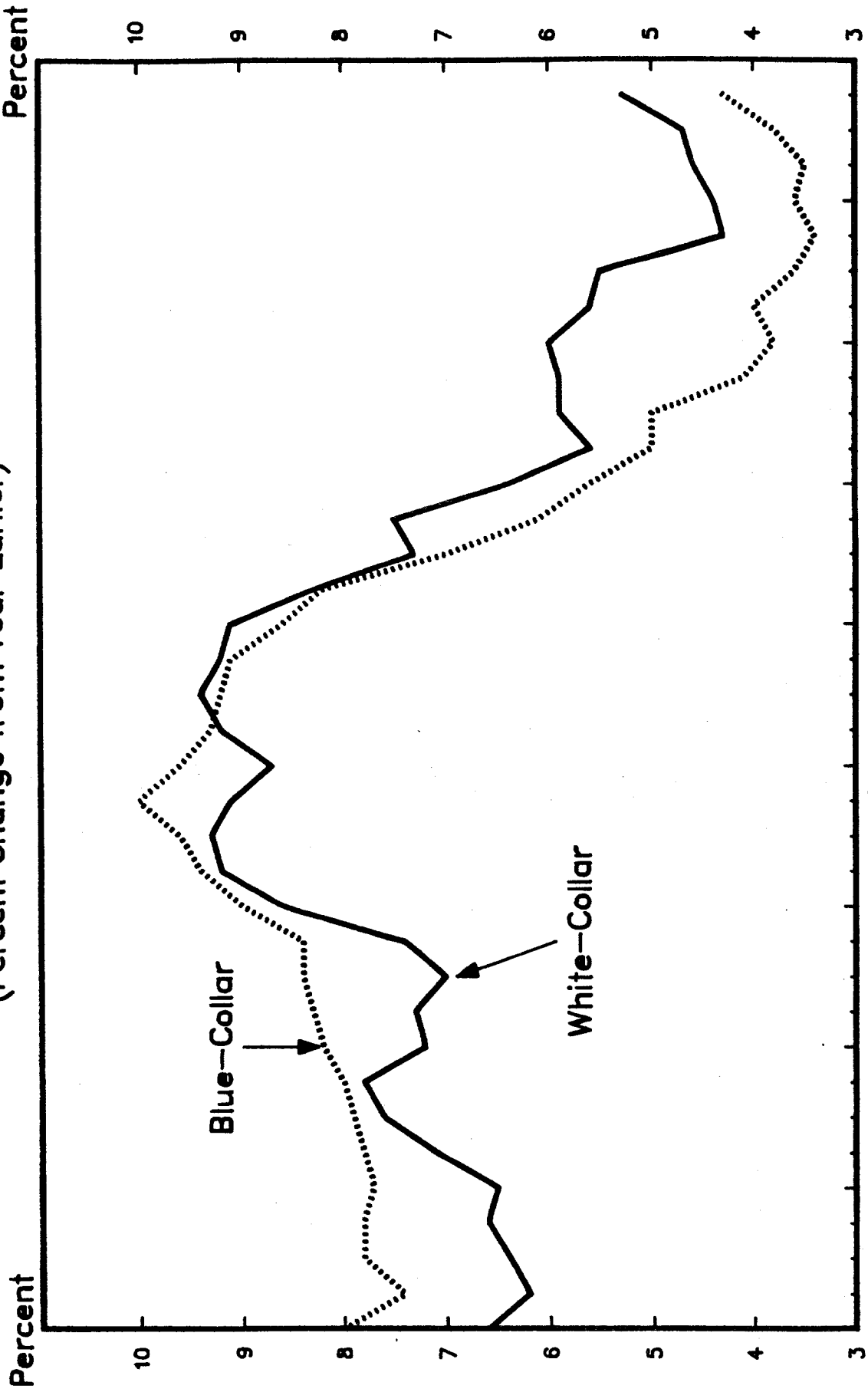

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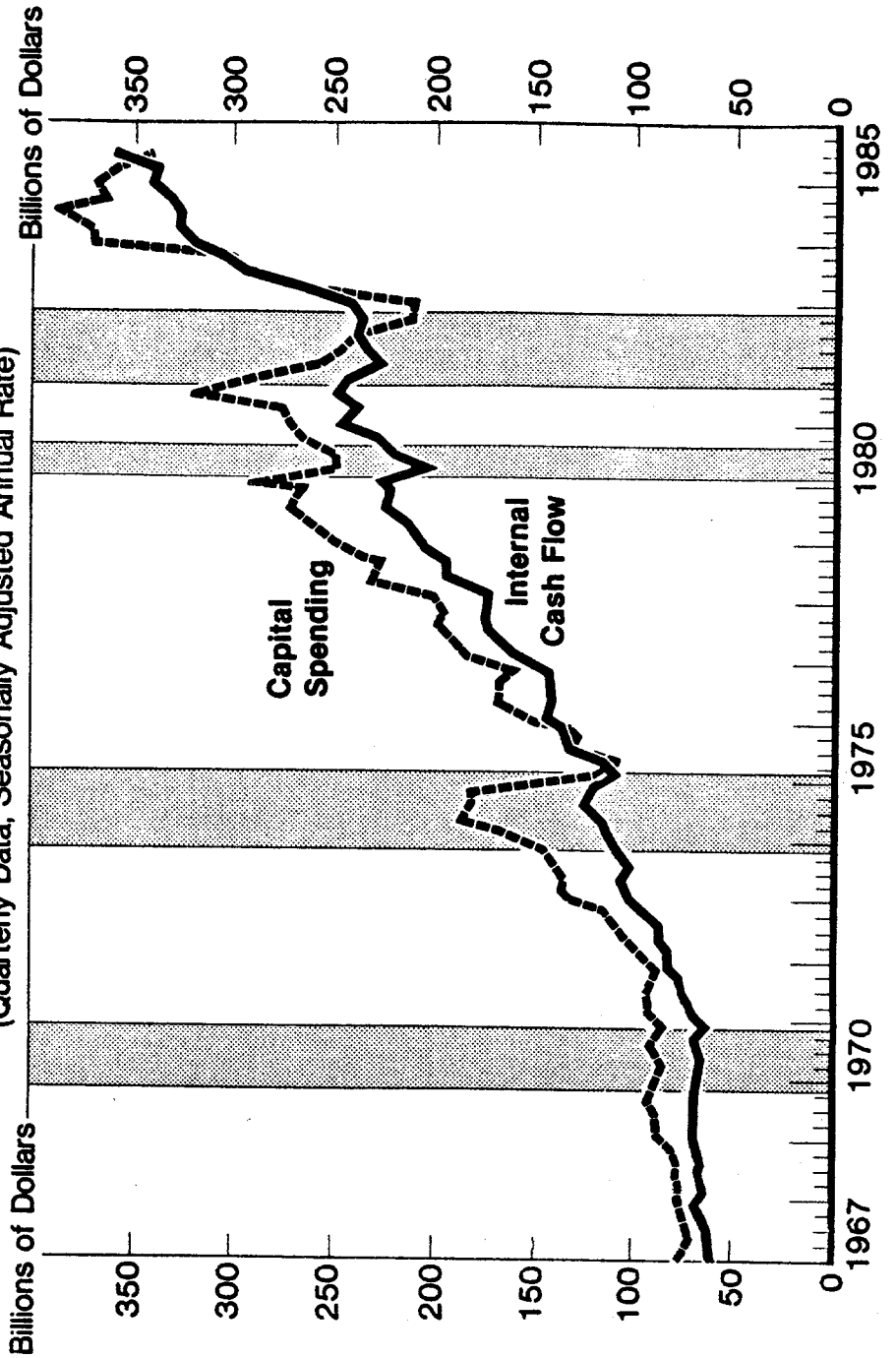
Chart 8

EXTERNAL CORPORATE FINANCING REQUIREMENTS

(Quarterly Data, Seasonally Adjusted Annual Rate)



Data for 1985-III estimated.

Source: Federal Reserve flow of funds accounts.

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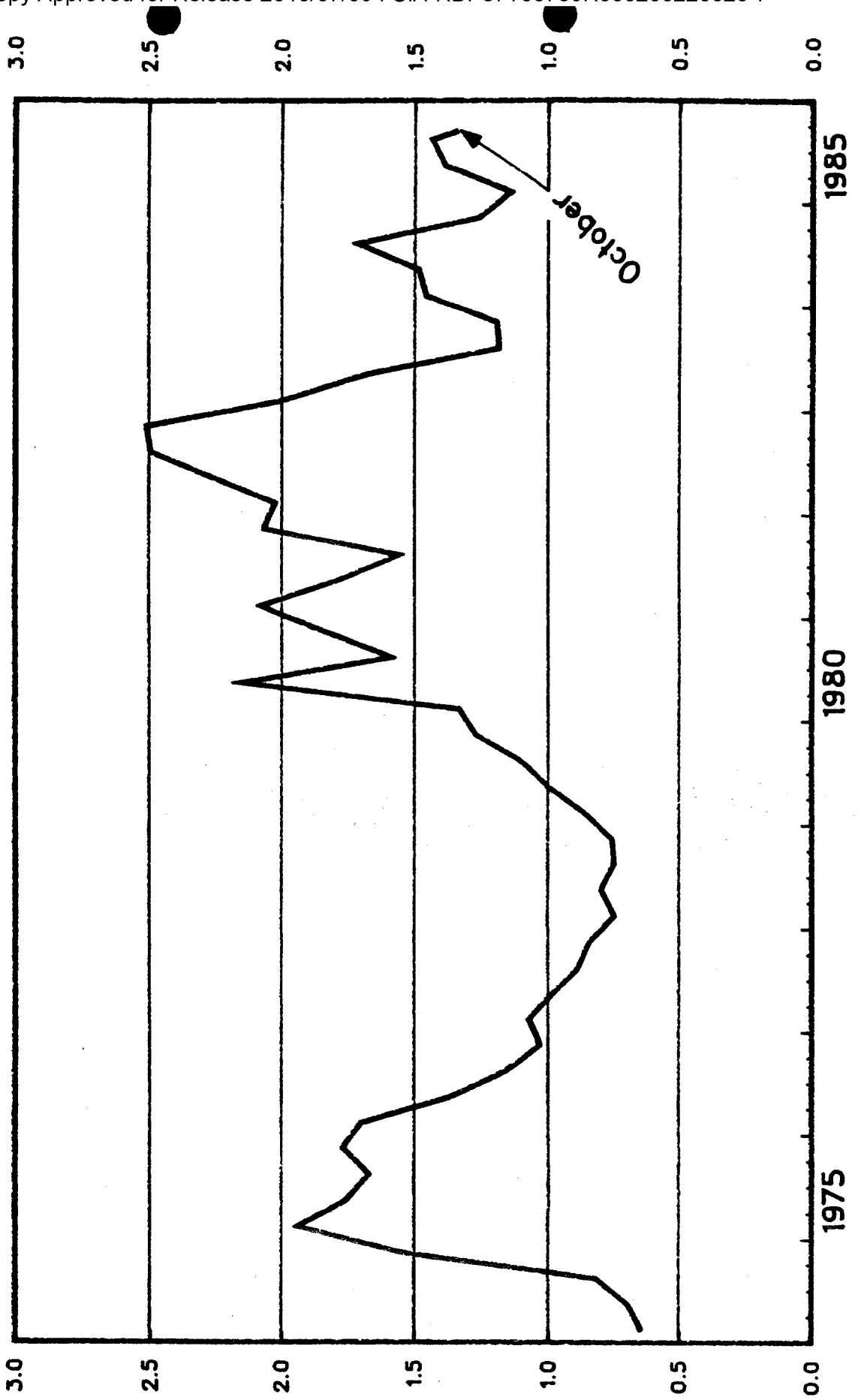
Chart 9

Yield Spread Between AAA Bonds and BAA Bonds



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DURATION OF POSTWAR EXPANSIONS

	Months
October 1945 to November 1948	37
October 1949 to July 1953	45
May 1954 to August 1957	39
April 1958 to April 1960	24
February 1961 to December 1969	106
November 1970 to November 1973	36
March 1975 to January 1980	58
July 1980 to July 1981	12
Average	
All postwar expansions	45
Peacetime expansions*	34
November 1982 to date	36

* Excluding expansions extending into Korean and Vietnam Wars.

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EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

AN ASSESSMENT OF THE STIMULUS FROM NET EXPORTS AND INVENTORIES

by

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Associate Director for Economic Policy
Office of Management and Budget

for

Economic Policy Council
November 7, 1985

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AN ASSESSMENT OF THE STIMULUS FROM NET EXPORTS AND INVENTORIES

Summary

The pulse of the economy quickened in the third quarter. Real GNP grew at a 3.3% seasonally adjusted annual rate, up from 1.9% the previous quarter. The 415 thousand gain in payroll employment in October indicates that this acceleration is continuing, but so far it has considerably less momentum than we had hoped. Two sectors, net exports and the change in business inventories, that have been a major drag on growth may soon provide new impetus to the economy. However, to maintain economic activity at a pace sufficient to reduce unemployment may require sustained growth of consumer and business spending.

During the last five quarters, a widening net export deficit and a swing from inventory accumulation to liquidation cut the gain in real GNP in half -- from the 4.4% rate it would otherwise have achieved to only a 2.2% annual rate. This contrasts with the first six quarters of this expansion when greater stockbuilding more than offset the drag from net exports. The other components of GNP, final sales to domestic purchasers, also contributed to the slowdown, decreasing from a growth rate of 6.7% in the first six quarters of the recovery to a 4.4% rate.

Net Exports, Inventories and Real Domestic Sales in this Expansion*

	First Six Quarters		Next Five Quarters	
	Change ($72 bill)	% (saar)	Change ($72 bill)	% (saar)
Net Exports	-35.5	---	-22.6	---
+ Inventories	44.9	---	-22.4	---
+ Final Sales to Domestic Purchasers	150.6	6.7	91.0	4.4
= GNP	160.0	7.1	46.0	2.2

* From trough in Q4/1982.

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Net Exports: Improvement Ahead

The story behind why the export sector should soon become a plus to the economy is summed up in one phrase -- the turn in the dollar. The reasons for the dollar's spectacular rise are many. They range from our economy's improved performance, to the high level of real interest rates, to foreign capital seeking a safe haven, to rigidities in the European economies. For many reasons the dollar rose and, with it, there followed a gradual deterioration in our balance of international trade.

Short lead-time items felt the impact first. Exports of farm commodities peaked in 1981. By the third quarter of this year, they had fallen 30% in real terms. Real exports of nonagricultural goods fell by 17% during the 1981-82 recession, more than in any recent business cycle downturn. Some of this reflected the sharp reduction in imports by debt-ridden LDCs which constitute 40% of the U.S. export market and the sluggish economic growth in the European countries, but a substantial part was related to the sharp rise in the dollar. Although nonagricultural exports picked up in 1983, the first year of the recovery, they have been stagnant now for several quarters.

The dollar's rise has had an even larger impact on our imports. From 1970 until 1980, when the dollar hit its low, constant dollar imports were growing 5% a year. Since then, imports have grown at twice that rate. Besides the dollar, the rapid growth of the U.S. in the initial two years of recovery relative to other major trading partners also contributed to the surge in imports.

But the trade-weighted dollar has fallen 20% since February, and is now 6% under its 1984 average. Imports of goods appear to have stabilized since the first quarter. That is somewhat exaggerated because we have run down our petroleum stocks and, in time, must rebuild them. Excluding petroleum, the worst of the rise in imports may well be behind us. We are now entering the period when exporters to the U.S. must choose whether to risk loss of market share or to cut prices as the dollar declines. Some imported categories are now well established in the U.S. market with distribution systems and marketing programs in place. Such companies may try hard to maintain market share. Although the response time may vary with different products, eventually dollar import prices must rise and the volume of imports will decline as a share of GNP.

Capital goods imports have long order lead-times. Even so, the decline in the dollar appears to have had some stabilizing effect on their import share. However, it may be late next year before we see any significant slippage in such long lead-time goods. For the same reason, it will be some time before exports accelerate. A third of our nonagricultural exports are capital goods.

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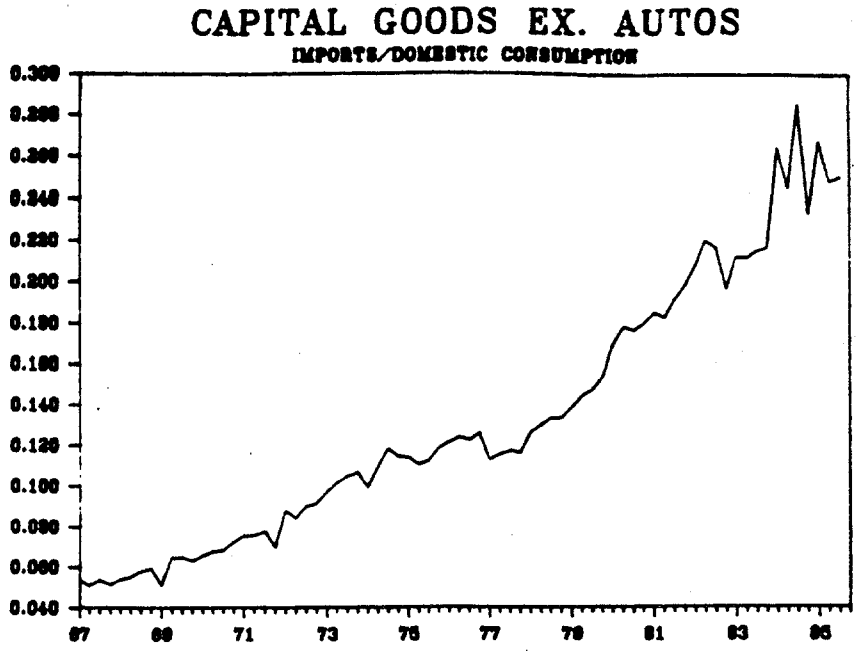

Still, the forces in the foreign sector have begun to run in our direction. As that momentum grows, it will become more and more likely that the change in net exports will add to GNP. Although the net export deficit may hold at current levels for a quarter or two, we should see a substantial improvement by next year.

The critical factor is whether the exchange value of the dollar continues to decline. Something more fundamental than central bank intervention will be required. The Finance Ministers at the G-5 meeting recognized that the U.S. would have to reduce its budget deficit to alleviate pressure on U.S. interest rates, while Japan and Germany would need to stimulate their economies. Such actions would strengthen foreign currencies against the dollar, boost U.S. exports, restrain imports, and reduce the trade deficit.

Instead of following this policy prescription, Japan and Germany have permitted their domestic interest rates to rise. Continuation of this trend would not help expand their economies. At the same time, U.S. fiscal policy adjustments have been stymied, leaving easy money as the default policy alternative to drive down the dollar. In short, the major countries appear to be using monetary policy to bring down the dollar when a fiscal policy mix would be more appropriate.

The Coming Boost from the Inventory Cycle

Inventory accumulation will also cease to be a drag on economic growth, and instead will provide a strong, but short-lived, boost to real GNP in the next few quarters. The story behind the upturn in inventories requires two phrases -- the change toward lengthening delivery times on orders in recent months and the relatively low level of inventory-to-sales ratios.

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Inventory accumulation accounts for only a small part of total GNP, but changes in inventories often dominate the economy's cyclical behavior. On average, inventory accumulation has not affected the trend growth of real GNP over the postwar period, but inventory change is significant during recessions and recoveries. Indeed, during recessions, inventory liquidation may account for 70% of the decline in real GNP.

Hence, swings in inventory accumulation accentuate the changes in real GNP, but the inventory cycle itself is essentially self-correcting. Inventory liquidation, no matter how severe, cannot forever accelerate. When acceleration stops, liquidation may continue, but its negative effect on GNP growth is halted.

To understand the automatic nature of the inventory cycle, however, it is necessary to go back a step. Inventory fluctuations are not necessarily the result of misjudging the market; they are an inherent part of the purchasing process. Some inventory volatility is inevitable as purchasing agents seek to maintain adequate stocks to satisfy demand and avoid production bottlenecks given varying delivery lead-times.

The purchasing agent is responsible for assuring that there are sufficient stocks on hand to meet the production schedule. When lead-times for delivery of additional materials are a week, the purchasing agent only needs to maintain a week's supply of goods in inventory. As long as this continues, the purchasing agent can maintain a steady flow of orders, and there will be little change in inventories.

Now suppose that delivery times lengthen, as they have recently. If suppliers need ten days, rather than seven, to fill their orders, the purchasing agent must adjust his order rate. If he does not, he will risk interrupting the production process.

In order to avoid affecting production schedules, the purchasing agent must increase his order rate. If a sufficient number of purchasing agents increase their orders in response to the initial increase in delivery times, the result is likely to be a further lengthening of lead-times as suppliers' order books fill. That, in turn, will lead to still further increases in orders until a new balance is struck between inventory holdings, production plans, and delivery times. The new balance is unstable, however, once purchasing agents arrive at that point, they must cut back their order rate to their consumption rate. Cutting back on their orders will enable their suppliers to speed up deliveries, which will encourage more cutbacks, and so the cycle goes on.

This brief sketch of how purchasing decisions are made shows inventory liquidation seldom lasts for very long. It is impossible to liquidate inventories at an ever-increasing rate. Long before inventories reach zero, there is a slowing in the rate at

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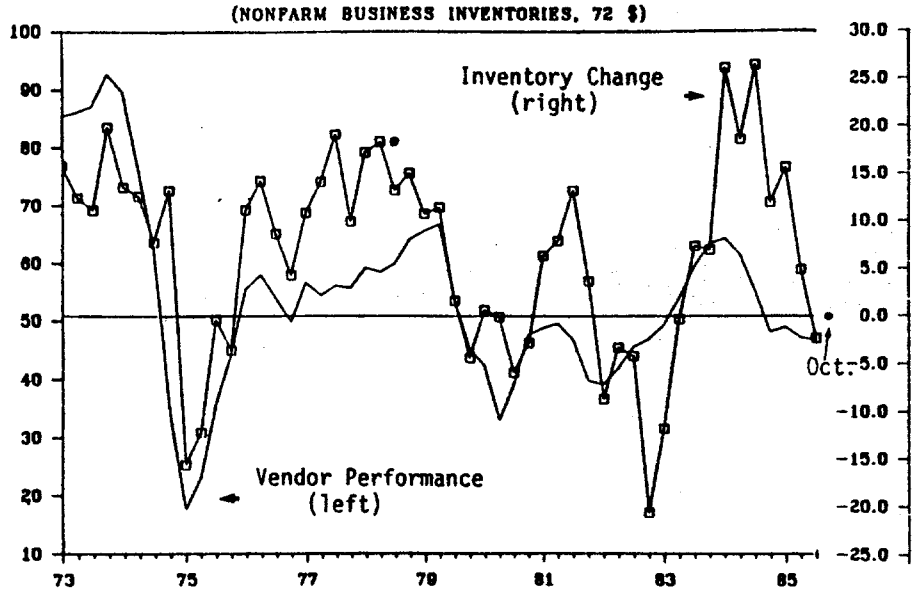
which inventories are being run down. That is the key to a reversal of the cycle. It is the change in the change in business inventories that turns the economy around. Once there is a slight change in direction, that change is likely to be amplified before it is reversed.

Present circumstances suggest a pick-up in inventory accumulation over the next few quarters. The chart and table below point to this conclusion. The chart plots vendor performance, a measure of delivery times, against inventory changes. It shows that, with a lag, as vendor performance rises, i.e., as delivery times lengthen, inventory accumulation increases. Vendor performance has been rising since July, a reversal of the downward trend that began in mid-1983 and indicating an imminent upturn in inventory change. Soon, increasingly larger additions to stocks should be boosting real GNP growth.

VENDOR PERFORMANCE & INVENTORY CHANGE



1985 Vendor Performance
(% of companies receiving slower deliveries)

Jan	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct
51.5	48.6	47.2	45.8	48.9	46.8	45.3	46.1	48.9	50.3

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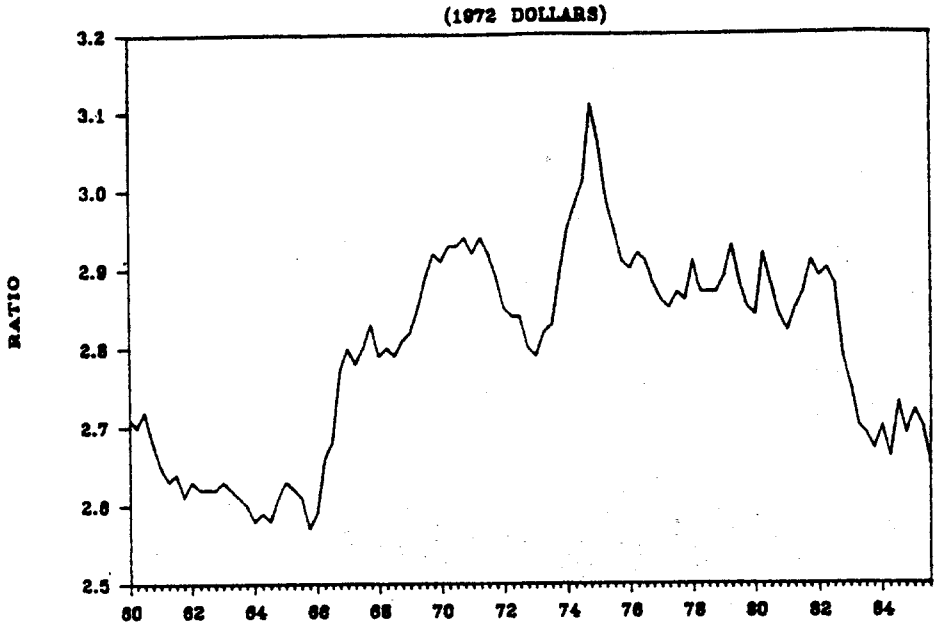
Once the inventory cycle moves into an upturn, it can continue along that track for a longer period than on the downside as a result of the underlying upward growth trend that is characteristic of a growing economy. It takes longer to build stocks to desired levels than it does to liquidate them. At present, the inventory/sales ratio is relatively low, as it was in the 1960s when inflation was also moderate. But with such low stocks, the desire to build stocks in the next few quarters may become quite strong.

NONFARM BUSINESS INVENTORY TO SALES



To Keep Expansion Going . . .

The impetus to growth from the improvement in net exports may continue throughout 1986 if the dollar continues to decline. But the boost from inventory accumulation is likely to wane as inventories come into balance with production schedules and suppliers' lead times. At that time, maintenance of real growth sufficient to bring down unemployment will depend on the growth of consumer and business spending.

Unfortunately, the outlook for business capital spending next year is not encouraging. Office building, which has been growing rapidly, is likely to turn down by late 1986 or 1987, given the high, and still rising, vacancy rate. The just completed McGraw-Hill survey of 1986 investment spending plans is quite weak. In nominal dollars, firms expect to reduce spending 2.1% next year. Assuming their estimate of a 4.7% increase in capital goods prices is correct, this would imply almost a 7% fall in real outlays (These figures are confidential until released on November 8.)

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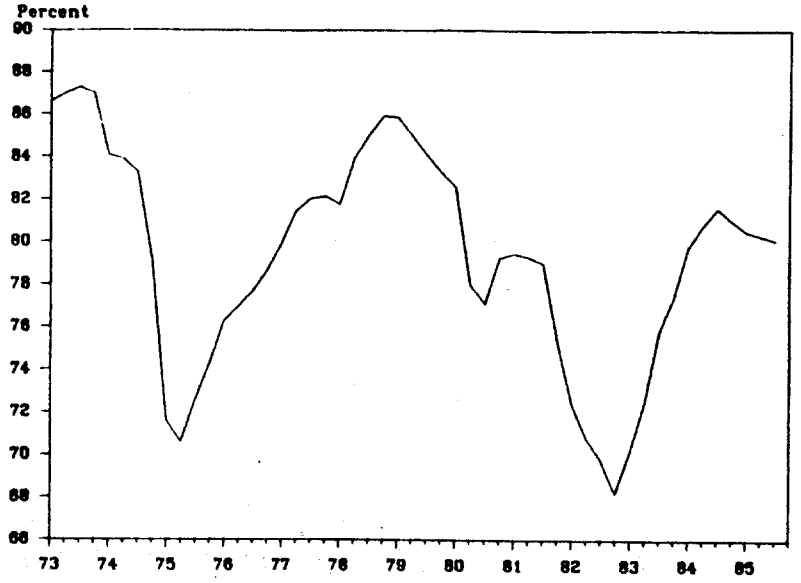
A slowing in investment is not surprising given the long time, five quarters, that the economy has been stuck on a slow growth path. During this period, operating rates have declined, profit margins narrowed, and cash flow slowed. Clearly, until these conditions are reversed -- and businesses, at present, do not see a marked improvement ahead -- there is little justification for additional investment unless it will significantly reduce costs. However, if the economy moves ahead at a moderately good pace for a couple of quarters, business may well change its capital spending plans.

MFG CAPACITY UTILIZATION RATE



Consumer spending may also begin to grow at a slower pace. Real consumer spending has been rising by 5% at an annual rate for the past three quarters, a remarkably strong performance for a sector which has an average historical growth rate of 3-1/2% per year. The increase in consumer outlays has far outstripped the gains in real income, causing the saving rate to decline to the lowest level in 35 years. Consumer installment loan delinquencies are on the rise and consumer debt burdens are at record high levels.

At least some of the third quarter spending was stimulated by cut-rate financing incentives offered to car buyers. These will not be continued, at least not in their earlier form; since the beginning of October, auto sales have dropped substantially. Consumers may continue spending at a pace stronger than their underlying income would seem to support for some time, but eventually their spending pace must match their means. When that happens, their contribution to real GNP growth will slacken.

Accordingly, we see a period of time in which inventories and net exports help to provide somewhat faster real growth to the economy. However, to achieve growth sufficient to bring down unemployment may require continued full participation from business and consumer sectors.

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